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# United States v. KPMG: Does Section 6103 Allow the IRS to Put Taxpayer Names on the Front Page of the Wall Street Journal

Beckett G. Cantley
*St. Thomas University School of Law*



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# *UNITED STATES v. KPMG*: DOES SECTION 6103 ALLOW THE IRS TO PUT TAXPAYER NAMES ON THE FRONT PAGE OF THE WALL STREET JOURNAL?

BECKETT G. CANTLEY[1]



## I. INTRODUCTION

On July 12, 2002, the headline of the Wall Street Journal (hereinafter WSJ) read "IRS Releases Names of People in Disputed KPMG Tax Shelters."[2] The article

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[1]Beckett G. Cantley (University of California, Berkeley, B.A., 1989; Southwestern University School of Law, J.D., cum laude, 1995; and University of Florida, College of Law, LL.M. in taxation, 1997) is a Professor of Law at St. Thomas University School of Law.

[2]Glenn R. Simpson & John D. McKinnon, *IRS Names People Who Used Disputed KPMG Tax Shelters*, WALL ST. J., July 12, 2002, at A1.

contained the names of several prominent taxpayers, including the current Republican nominee for Governor of California,[3] a deceased champion stock car racer,[4] a deceased former Secretary of the Treasury,[5] and the CEOs of several public companies.[6] The article had culled the names of the taxpayers from a public filing of a lawsuit instigated by the Internal Revenue Service (hereinafter IRS) against KPMG LLP (hereinafter KPMG), a "Big Four" accounting firm.[7] The lawsuit[8] between the IRS and KPMG was a summons enforcement action in which the IRS was requesting KPMG to turn over certain taxpayer documents relating to alleged tax shelters promoted by KPMG[9] and entered into by the named taxpayers. KPMG had previously invoked attorney-client and section 7525 privileges[10] on behalf of the taxpayers in an attempt to prevent the release of the taxpayer documents to the IRS.[11] As part of the invocation of privilege, KPMG had to provide the IRS with a privilege log that set forth the names of the taxpayers relating to the alleged privileged documents.[12] Historically, the names of taxpayers in such a privilege log would not

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[3]*Id.* (listing William E Simon, Jr., Republican nominee for Governor of California as one of the clients of KPMG's disputed tax shelters).

[4]*Id.* (naming Dale Earnhardt, deceased former world champion stock car driver, as a client of KPMG).

[5]*Id.* (releasing the name of William E. Simon, Sr., former Secretary of the Treasury, as having relationships with the alleged KPMG tax Shelters).

[6]*Id.* Henry Nicholas III, CEO of Broadcom Corp., Robert K. Shaye, Chairman of New Line Cinema, and Richard J. Heckermann, former Chairman of U.S. Filter Corp., were all named in the Wall Street Journal article.

[7]The current "Big Four" accounting firms include KPMG, Deloitte & Touche, PricewaterhouseCoopers and Ernst & Young.

[8]United States of America v. KPMG LLP, *Petition to Enforce Internal Revenue Service Summonses*, No. 1:02MS00295 (D.D.C. filed July 9, 2002) [hereinafter Petition].

[9]*Id.* Taxpayer information was being sought for several different alleged tax shelters, including alleged tax shelters named the Foreign Leveraged Investment Program [hereinafter FLIP] and the Offshore Portfolio Investment Strategy [hereinafter OPIS].

[10]I.R.C. § 7525(a)(1) (2002) provides that:

> With respect to tax advice, the same common law protections of confidentiality which apply to a communication between a taxpayer and an attorney shall also apply to a communication between a taxpayer and any federally authorized tax practitioner to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney.

*Id*.

[11]*See generally*, Justice Department, *Privilege Log for January 28, 2002 Summons to KPMG LLP*, reprinted in *KPMG Privilege Log Released by Justice Department*, 2002 TAX NOTES TODAY 140-83 (July 10, 2002).

[12]For example, one of the summons issued by the IRS required KPMG to provide all information pertaining to three of KPMG's tax shelter transactions. These transactions referred to as BLIP, BLIPS, TRAC, TRACT and IDV by KPMG's record provided in pertinent part:

> If a privilege is being claimed with respect to any requested document or information, state with specificity the nature of the privilege and the extent of all allegedly

be released by the IRS, even in a summons enforcement action.[13] The publication of names caused a large backlash among certain commentators[14] and Freedom of

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privileged matters. If you object to producing only part of a document, provide us with a redacted copy and retain the original for review by a court (the part to which you object and produce the remainder). With respect to each allegedly privileged document, or portion of a document, provide the following:

1. The date appearing on such document or, if has no date, the date or approximate date that such document was created;
2. The identity or descriptive code number, file number, title, or label of such document used by the custodian of the document to identify it for retrieval;
3. The general nature and description of such document and the identity of the person who signed such document and, if it was not signed, the response shall so state and give the identity of the person(s) who prepared it;
4. The identity of the person to whom such document was addressed and the identity of each person other than such addressee to whom such document, or a copy thereof were given or sent at any time;
5. The identity, if known, of the person having or who may have present possession, custody, or control of such document or a copy thereof; and
6. Whether or not any draft, copy, or reproduction of such document contains any postscripts, notation, change, or addendum not appearing on the document itself and, if so, the response shall give the description of each such draft, copy or reproduction."

Petition, *supra* note 8.

[13]The fact that taxpayer names are historically redacted from such public documents was underscored by the IRS Chief Counsel in a letter to the editors of the Wall Street Journal when he stated:

> We take seriously our public responsibilities to preserve confidences, including, wherever possible, the names of innocent third parties. It is for this reason that documents revealing the identity of third parties is unnecessary to the conduct of litigation are often redacted or filed under seal to protect their privacy.

*See* Internal Revenue Service & Justice Department, *IRS and Justice Letter on KPMG Privilege Log Disclosure*, 2002 TAX NOTES TODAY 145-71 (July 19, 2002).

[14]For example, the Wall Street Journal wrote a scathing editorial article entitled "*The IRS Out of Control*" that stated in pertinent part:

> We knew the Internal Revenue Service's tax-collection arsenal included, among other things, the legal right to audit, sue and penalize tax cheats. But until last week we didn't know the agency had license to *gratuitously humiliate innocent taxpayers* in the process.
>
> On Friday, the Journal reported on page one that the IRS has disclosed the names of hundreds of citizens engaged in what amounts to tax planning. These individuals – many of them prominent businessmen – *are accused of no wrongdoing*. Their only sin is that they are clients of KPMG, the accounting firm currently doing battle in court with the IRS.
>
> Last week the Justice Department sued KPMG on behalf of the IRS. The government alleged that some of KPMG's tax shelters are illegal and requested the names of clients who had inquired about them. The accounting firm complied, providing the names in a so-called "privilege log" to protect their identities. The IRS promptly whent public with the names, *blithely smearing the reputations of innocent third-party individuals* in an effort to strong-arm its court opponent and embarrass its clients.
>
> This is a dangerous and outrageous precedent. To begin with, not all tax shelters are illegal, and a court has to rule on the ones in question. Nor is it against the law to

Information Act requests were sent to the U.S. Treasury Department,[15] the IRS[16] and the U.S. Department of Justice (hereinafter DOJ)[17] seeking to discover internal government documents as to who made this decision and how it was made.

Section 6103 of the Internal Revenue Code of 1986 (hereinafter the Code) provides that certain taxpayer information is confidential as between the IRS and the taxpayer, subject to certain exceptions.[18] Section 7431 of the Code provides redress for taxpayers in which such confidential taxpayer information is improperly released.[19] What follows is a discussion of whether the disclosure activities of the

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> minimize one's tax burden. In fact it's common sense, and *private citizens shouldn't be smeared in government press releases or news leaks* for trying. …
>
> Not long ago, Congress was curtailing IRS abuses. Perhaps post-Enron, the tax man feels as if he can once again get away with anything, even *harassing honest Americans*. The agency falls under the purview of Treasury Secretary Paul O'Neill and clearly needs adult supervision. He might start by firing or sending to Siberia whoever was responsible for this *abuse of government power*."

*The IRS Out of Control*, WALL ST. J., July 17, 2002, at A16 (emphasis added).

[15]Tax Analysts sent a Freedom of Information Act [hereinafter FOIA] request to the U.S Treasury Department seeking several documents, as described below:

> In particular, the FOIA request seeks any materials discussing the decision to attach privilege logs containing KPMG client names. … Tax Analysts has asked for copies of any documentation discussing the decision to release to the press the petitions and some attachments on the day filed, and the court filings in electronic form soon afterward. The FOIA requests also seek memos or documents relating to the letters to the editor of the Wall Street Journal that were written by officials in the Treasury, IRS, and Justice Department, including draft versions of the letters.

William A. Dobrovir, *Tax Analysts Files FOIA Request for Treasury's Shelter Summonses Enforcement Memos*, 2002 TAX NOTES TODAY 153-28 (August 6, 2002).

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*Id*. at 153-39.

[17]Tax Analysts sent a FOIA request to the U.S Justice Department seeking several documents, as described below:

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*Id*. at 153-41.

[18]26 U.S.C. § 6103 (2002).

[19]I.R.C. § 7431.

IRS in the KPMG case have violated the provisions of section 6103 of the Code and whether there is taxpayer redress for such violations under section 7431 of the Code

## II. SUMMONS ENFORCEMENT ACTION DISCLOSURE

The IRS has been waging a war with the "Big Five"[20] (now "Big Four")[21] accounting firms and certain other promoters[22] for years over their alleged marketing of tax shelters.[23] For example, after a long battle, the IRS recently came to a global agreement with one of the Big Four, PricewaterhouseCoopers (hereinafter PWC) that will settle tax shelter registration and maintenance issues relating to tax shelters PWC has marketed.[24] On January 28, 2002, the IRS issued its first summons to KPMG, requesting information related to two alleged tax shelters[25] allegedly promoted by KPMG.[26] Several other summonses were later issued for additional alleged tax shelters allegedly promoted by KPMG.[27] In response to the summons, KPMG put together a privilege log containing a list of documents relating to participants in the alleged tax shelters as well as providing the IRS with approximately 84 boxes of documents as well as the sworn testimony of certain individuals.[28] In response to KPMG's document production and privilege log, the IRS refuted KPMG's privilege claim and claimed that KPMG needed to turn over the remaining documents on the privilege log that had yet to be turned over to the IRS as well as many other documents.[29] On July 9, 2002, the IRS filed suit seeking

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[20]Prior to the collapse of Arthur Andersen, the "Big Five" accounting firms included Arthur Andersen, KPMG, Deloitte & Touche, PriceWaterhouseCoopers and Ernst & Young.

[21]The current "Big Four" accounting firms include KPMG, Deloitte & Touche, PriceaterhouseCoopers and Ernst & Young.

[22]Another example of an alleged promoter of tax shelters being pursued by the IRS was the accounting firm of BDO Seidman, LLP, which also was the subject of a summons enforcement action on the same date that the KPMG summons enforcement action was filed. *See* David L. Lupi-Sher, *IRS Moves Aggressively Against Accounting Firms Marketing Tax Shelters*, 2002 TAX NOTES TODAY 133-4 (July 10, 2002).

[23]Tax Notes Today has reported that all the former Big Five accounting firms have been served with summonses relating to the alleged promotion of tax shelters. *See* Sheryl Stratton, *PWC Deal Heads Off Shelter Summons Enforcement*, 2002 TAX NOTES TODAY 125-1 (June 27, 2002).

[24]*Id*. On June 27, 2002, the IRS announced that it had reached a deal with PricewaterhouseCoopers [hereinafter PWC] that will result in PWC paying a "substantial payment" to the IRS, PWC providing certain client information to the IRS in response to summonses, and PWC developing processes to ensure ongoing compliance with the tax shelter registration and investor list maintenance requirements.

[25]The two alleged tax shelters were the FLIP and the OPIS strategies. *See* Petition, *supra* note 8.

[26]*See* Lupi-Sher, *supra* note 22, at 133-34.

[27]*See* Petition, *supra* note 8.

[28]*See* Lupi-Sher, *supra* note 22, at 133-34.

[29]The IRS claimed that KPMG had failed to produce 1,129 of the 1,162 documents listed in the privilege log. *See* Petition, *supra* note 8.

to enforce the civil summonses against KPMG.[30] As part of its petition to enforce the civil summonses, the IRS attached the KPMG privilege log that listed the documents KPMG considered to be privileged.[31] However, the IRS failed to redact the names of the taxpayers whose documents were contained in the privilege log, even though the taxpayers were not parties to the IRS enforcement action.[32] As a result, the names of the taxpayers became public record and were printed in the WSJ shortly after the privilege log was made public[33] as well as other media outlets.[34]

On July 19, 2002, the IRS Office of Chief Counsel issued new guidelines for the review and disclosure of privilege logs or similar documents that identify third parties in court, including summons enforcement actions.[35] The guidelines require that IRS counsel should closely examine any privilege log or similar document that will be made public and it should be presumed that the names of third parties who are not parties to the litigation be redacted from the privilege log before the privilege log is made public.[36] Thus, the guidelines indicate that the IRS has apparently recognized the error of its ways in the KPMG case.[37] The open question is whether current law allows redress to the taxpayers that were named in the KPMG case prior to the revised guidelines.

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[30]*Id.*

[31]*Id.*

[32]*Id.*

[33]*Id.*

[34]Tax Notes Today reported that the more prominent names listed in the privilege log were disclosed in Forbes Magazine, the New York Times and Bloomberg. *See* Stratton, *supra* note 23, at 145-48.

[35]*See* Internal Revenue Service, *IRS Releases Requirements for Disclosure of Third-Party Information in Privilege Logs*, 2002 TAX NOTES TODAY 140-6, (July 19, 2002) [hereinafter IRS Release].

[36]*Id.*

[37]This mea culpa was further evidenced by a letter written by the IRS Chief Counsel to the editors of the Wall Street Journal stating:

> We agree with the concerns expressed in your editorial of July 17 that no taxpayer should be "gratuitously humiliated" in court proceedings. We take seriously our public responsibilities to preserve confidences, including, wherever possible, the names of innocent third parties. It is for this reason that documents revealing the identity of third parties is unnecessary to the conduct of litigation are often redacted or filed under seal to protect their privacy.
>
> We want to reiterate that the facts that individuals were listed by KPMG on the privilege log filed in this suit does not necessarily mean that these individuals participated in tax shelters. Nevertheless, it is clear in hindsight that, while such disclosure was permissible, it would have been better practice to redact the names from KPMG's privilege log before it was filed in federal court or to ask the court's permission to file it under seal. The Office of Chief Counsel of the Internal Revenue Service and the Tax Division of the Department of Justice are working on procedures that should avoid similar missteps in the future."

IRS Release, *supra* note 35, at 145-71.

## III. SECTION 6103

### *A. General Rule*

#### 1. The Law and Public Policy

Section 6103(a) sets forth the general rule that taxpayer "return information" is generally confidential, subject to certain exceptions.[38] Section 6103(b)(2) provides that "return information" includes taxpayer names as well as other information.[39] Additionally, commentators have indicated that the definition of "return information" has evolved to include virtually all information collected by the IRS regarding a person's tax liability.[40]

Congress was specific in its rationale for enacting section 6103. The Congressional Record indicates that section 6103 was enacted to protect the taxpayer's privacy and to ensure that confidential information obtained by the IRS in the course of collecting tax information is not misused.[41] In the Tax Reform Act of 1976, Congress reformed section 6103 and eliminated executive discretion regarding what information could be disclosed to which Federal agencies and established that tax information is confidential and is only subject to disclosure to the extent explicitly provided by the Code.[42] Congress made this change having determined

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[38] 26 U.S.C. § 6103(a) provides in pertinent part:

(a) General Rule.

Returns and return information shall be confidential, and except as authorized by this title-

(1) No officer or employee of the United States,

(2) No officer or employee of any State, any local law enforcement agency receiving information under subsection (i)(7)(A), any local child support enforcement agency, or any local agency administering a program listed in subsection (l)(7)(D) who has or had access to returns or return information under this section, and

(3) No other person (or officer or employee thereof) who has or had access to returns or return information under subsection (e)(1)(D)(iii), paragraph (6), (12), or (16) of subjection (l), paragraph (2) or (4)(B) of subsection (m), or subsection (n), shall disclose any return or return information obtained by him in any manner in connection with his services as such an officer or an employee or otherwise or under the provisions of this section. For purposes of this subsection, the term "officer or employee" includes a former officer or employee.

*Id*.

[39] 26 U.S.C. § 6103(b)(2)(A) provides in pertinent part that "return information" means-"a *taxpayer's identity,* the nature, source, or amount of his income, payments, receipts, deductions, exemptions, credits, assets, liabilities, net worth, tax liability, tax withheld, deficiencies, over assessments, or tax payments. …" *Id.* (emphasis added)

[40] *See* Allan Karnes & Roger Lirely, *Striking Back At the IRS: Using Internal Revenue Code Provisions To Redress Unauthorized Disclosures of Tax Returns or Return Information*, 23 SETON HALL L. REV. 924, 933 (1993).

[41] *See* S. Rep. No. 938, 94th Cong., 2d Spec. Sess. 19, 317-18 (1976).

[42] The U.S. Treasury Department reported in 2000 that:

that taxpayers must have a reasonable expectation that their information would be kept private by the IRS.[43] Congress also determined that if this expectation of privacy was abused, the public would lose confidence in the tax system itself.[44]

The U.S. Treasury Department has previously listed several examples of where breaches of taxpayer confidentiality have led to compliance problems, including problems associated with the refund offset program,[45] problems associated with needs-based government programs,[46] and problems relating to qualifying for credit.[47]

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> By the mid-1970's, there was increased Congressional and public concern about the widespread use of tax information by government agencies for purposes unrelated to tax administration. This concern culminated with a *total revision of section 6103* in the *Tax Reform Act of 1976*. There, Congress *eliminated Executive Discretion* regarding what information could be disclosed to what Federal and state agencies. Under this second approach, Congress established a new statutory scheme in which *tax information was confidential and not subject to disclosure except to the extent explicitly provided in the Code*. Although there have been many amendments to the law since that time, the basic statutory scheme established in 1976 remains in place today.

*Report to The Congress on Scope and Use of Taxpayer Confidentiality and Disclosure Provisions*, Volume I: Study of General Provisios*,* Office of Tax Policy, Department of the Treasury, (Oct. 2000), Part Two, Section II, Paragraph A, at page 15 (emphasis added)

[43]The U.S. Treasury Department reported in 2000 that:

> Congress recognized that the IRS had more information about citizens than any other Federal agency, and that other agencies routinely sought access to that information. Congress also recognized that citizens *reasonably expected* that the *tax information* they were required to supply to the IRS *would be kept private*.

*Report to The Congress on Scope and Use of Taxpayer Confidentiality and Disclosure Provisions*, Volume I: Study of General Provisions, Office of Tax Policy, Department of the Treasury, (October, 2000), Part Two, Section II, Paragraph B, Subparagraph 5, at page 21 [hereinafter *Taxpayer Confidentiality*] (emphasis added).

[44]The U.S. Treasury Department reported in 2000 that: "Congress also recognized that citizens *reasonably expected* that the *tax information* they were required to supply to the IRS *would be kept private*. If the IRS abused that reasonable expectation of privacy, the *loss of public confidence* could *seriously impair the tax system*." *Id*. (emphasis added).

[45]The U.S. Treasury Department reported in 2000 that:

> Breaching the confidentiality of returns and return information can affect compliance in several ways. For example, the IRS determined that as a result of the institution of the *refund offset program*, *some taxpayers changed their withholding* (so that there would be no refund to offset) and a greater number of taxpayers stopped filing returns altogether. [Footnote 72: Over the period 1985-1988, the IRS found that $719 million was lost due to an increase in nonfilers, accounting for $621 million of the total, and an increase in balance-due filers, accounting for the remaining $98 million. Over this same period, approximately $1.3 billion was offset from the same population. See IRS Research Division, The Impact of Nontax Refund Offsets on Voluntary Compliance (Rev. 2/93) at 5-4.]… [T]he integrity of data provided to the IRS by taxpayers is undermined, diminishing the utility of the data for the very purpose for which it was originally collected and ultimately disclosed.

*Id.* at 34 (emphasis added).

[46]The U.S. Treasury Department reported in 2000 that:

> Overtly tying tax reporting to *needs-based government benefits* may lead some individuals to *underreport their income* in order to qualify for some benefits, thus

In addition, the U.S. Treasury Department has found that "[t]axpayers who view the IRS as a resource for a variety of other interests will be less inclined to voluntarily turn over sensitive financial information out of a fear of where it might ultimately land."[48]

The case law also is very clear that taxpayer confidentiality should be a strong policy goal in tax administration. For example, the court in *Diamond v. U.S*[49]stated that the legislative purpose of creating section 6103 was to "strengthen taxpayers' rights,"[50] specifically to provide definitive rules relating to the confidentiality of tax returns due to the prior abuses in that area.[51] Similarly, in *Flippo v. United States*,[52] the court discussed the fact that "our voluntary assessment system of tax action is in large measure dependent upon the realization of a taxpayer's expectation that the information required of him would be kept confidential."[53]

Moreover, the *Internal Revenue Manual, Handbook for Special Agents* (hereinafter Manual) also makes it clear that IRS agents should maintain taxpayer confidentiality. The Manual provides that: "Caution must be exercised not [to] damage the reputation of the taxpayer" by making disclosures, even if necessary, either "offensive or suggestive of any wrongdoing by the taxpayer."[54] The Manual also warns its agents against even limited or [circular] "mail circularization that may result in unwarranted embarrassment to the taxpayer."[55]

2. Application to KPMG Enforcement Action

It is very likely that the IRS disclosure of the confidential taxpayer information violates the general rule of section 6103(a). The IRS disclosed the names of taxpayers by disclosing the unredacted privilege log in the KPMG petition.

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> jeopardizing tax collections…. [T]he integrity of data provided to the IRS by taxpayers is undermined, diminishing the utility of the data for the very purpose for which it was originally collected and ultimately disclosed.

*Id.* (emphasis added).

[47]The U.S. Treasury Department reported in 2000 that:

> Conversely, overtly tying tax reporting to the *ability to qualify for loans, credit*, etc., may lead some individuals to *over*report their income. … [T]he integrity of data provided to the IRS by taxpayers is undermined, diminishing the utility of the data for the very purpose for which it was originally collected and ultimately disclosed.

*Id.* (emphasis added).

[48]*See Taxpayer Confidentiality, supra* note 43, at 34.

[49]944 F.2d 431 (8th Cir. 1991).

[50]*Id.* at 434 (citing H.R. Rep. No. 658, 94th Cong., 1st Sess. 7 (1975)).

[51]*Id.* at 437.

[52]670 F. Supp. 638 (W.D. N.C. 1987), *aff'd*, 849 F.2d 604 (4th Cir. 1988).

[53]*Id.*

[54]Internal Revenue Service, *Internal Revenue Manual*, *Handbook for Special Agents*, § 347.2 at 9781-11.

[55]*Diamond*, 944 F.2d at 434 (citing to Internal Revenue Service*, Internal Revenue Manual, Handbook for Special Agents* § 347.1).

Taxpayer names are considered "return information" under section 6103.[56] As such, the IRS violated the general rule of section 6103(a) regarding the disclosure of confidential "return information."[57]

In addition, the disclosure was a clear violation of public policy with respect to the named taxpayers. As discussed above, there exists a strong public policy against such disclosures as indicated by legislative history,[58] the U.S. Treasury Department,[59] case law,[60] and the Manual.[61]

### *B. Exceptions*

Two of the exceptions which permit disclosure of "return information" are disclosure to certain Federal officers and employees for purposes of tax administration, including the Department of Justice[62] and disclosures made in judicial and administrative proceedings.[63] These two exceptions were created by Congress in order to balance concerns about maintaining taxpayer confidences and the integrity of the tax system with the need of certain government agencies' need to view the information.[64]

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[56]26 U.S.C. § 6103(b)(2)(A) provides in pertinent part that "return information" means-"a *taxpayer's identity,* the nature, source, or amount of his income, payments, receipts, deductions, exemptions, credits, assets, liabilities, net worth, tax liability, tax withheld, deficiencies, over assessments, or tax payments. …" *Id.* (emphasis added)

[57]26 U.S.C. § 6103(a) provides in pertinent part:

(a) General Rule.

Returns and return information shall be confidential, and except as authorized by this title-

(1) No officer or employee of the United States,
(2) No officer or employee of any State, any local law enforcement agency receiving information under subsection (i)(7)(A), any local child support enforcement agency, or any local agency administering a program listed in subsection (l)(7)(D) who has or had access to returns or return information under this section , and
(3) No other person (or officer or employee thereof) who has or had access to returns or return information under subsection (e)(1)(D)(iii), paragraph (6), (12), or (16) of subjection (l), paragraph (2) or (4)(B) of subsection (m), or subsection (n),shall disclose any return or return information obtained by him in any manner in connection with his services as such an officer or an employee or otherwise or under the provisions of this section. For purposes of this subsection, the term "officer or employee" includes a former officer or employee.

*Id*.

[58]S. Rep. No. 938, 94th Cong., 2d Sess. 19, 317-18 (1976).

[59]*Taxpayer Confidentiality, supra* note 43, at 34.

[60]*Diamond,* 944 F.2d at 431.

[61]*Id.* (citing to Internal Revenue Service, *Internal Revenue Manual, Handbook for Special Agents* 347.1).

[62]26 U.S.C. § 6103(h)(2).

[63]26 U.S.C. § 6103(h)(4).

[64]The U.S. Treasury Department reported in 2000 that:

### 1. Department of Justice Exception

#### *a. General Rule*

One of the exceptions that allows disclosure of "return information" involves a necessary disclosure to the Department of Justice in a court proceeding.[65] IRC section 6103(h)(2) provides in pertinent part that:

> In a matter involving tax administration, a return or return information shall be open to inspection by or disclosure to officers and employees of the Department of Justice (including United States attorneys) personally and directly engaged in, and *solely for their use in*, *any proceeding before a Federal grand jury or preparation for any proceeding (or investigation which may result in such a proceeding) before a Federal grand jury or any Federal or State court, but only if-the taxpayer is or may be a party to the proceeding*, or the proceeding arose out of, or in connection with, determining the taxpayer's civil or criminal liability, or the collection of such civil liability in respect of any tax imposed under this title;[66]
>
> the treatment of an item reflected on such return is or may be related to the *resolution of an issue* in the proceeding or investigation;[67] or
>
> such return or return information relates or may relate to a transactional relationship between a person who is or may be a party to the proceeding

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> Although Congress felt that the flow of tax information should be more tightly regulated, not everyone agreed where the lines should be drawn. The debates on accessibility were most heated in the area of nontax criminal law enforcement. One side, led by Senator Long, sought more liberal access rules in order to fight white collar crime, organized crime, and other violations of the law. This side felt 'the Justice Department is part of this Federal Government. It is all one Government.' [122 Cong. Rec. 23996 (July 27, 1976)(statement of Sen. Long)]. The other side, led by Senator Weicker, wanted very restrictive rules. This side recognized that it was cheaper and easier for the Justice Department to come directly to the IRS. But they also felt that when citizens prepared their tax returns, they prepared them for the IRS, and no one else.
>
> Ultimately, Congress amended section 6103 to provide that tax returns and return information are confidential and are not subject to disclosure, except in limited situations, as delineated by the Code, where disclosure is warranted. In each area of allowable disclosure, Congress attempted to *balance the particular office or agency's need for the information with the citizen's right to privacy*, as well as the *impact of the disclosure upon the continuation of compliance with the voluntary tax assessment system*. [Staff of the Joint Committee on Taxation, 94th Cong., 2d Sess., *General Explanation of the Tax Reform Act of 1976*, 313-16 (Comm. Print 1976)]. In short, Congress undertook direct responsibility for determining the types and manner of permissible disclosures.

*Taxpayer Confidentiality*, *supra* note 43, at 22 (emphasis added).

[65] 26 U.S.C. § 6103(h)(2).

[66] 26 U.S.C. § 6103(h)(2)(A) (emphasis added).

[67] 26 U.S.C. § 6103(h)(2)(B) (emphasis added).

and the taxpayer which affects, or may affect, the resolution of an issue in such proceeding or investigation."[68]

*b. Application to KPMG Enforcement Action*

It is unlikely that the first of the three above exception subsections (hereinafter DOJ Collection Exception)[69] applies to the KPMG case. The summons enforcement action was directed at KPMG and not the named taxpayers. The summons enforcement action proceeding did not arise out of, or in connection with, determining the named taxpayer's civil or criminal liability, or the collection of the named taxpayer's civil tax liability. While it is possible that at some point, the named taxpayers could become a party to the proceeding, this possibility does not appear strong enough to allow for an exception to the general rule regarding taxpayer confidentiality. In addition, the IRS has yet to allege that the named taxpayers owe additional taxes, interest or penalties in the summons enforcement action. Rather, the IRS is in the information gathering stage in the summons enforcement action, making a current disclosure of the named taxpayer's information premature with respect to the DOJ Collection Exception's application.

It is also unlikely that the second of the three above exception subsections (hereinafter DOJ Resolution Exception)[70] applies to the KPMG case. The summons enforcement action was not seeking to resolve the treatment on the return of KPMG, who was the "taxpayer" in the summons enforcement action. It is certainly possible that the named taxpayers' returns could become a subject to examination by the IRS, this proceeding has not called the named taxpayers' returns into question. As such, making a current disclosure of the named taxpayer's information does not appear to be covered by the DOJ Resolution Exception.

The third of the above exception subsections is the most likely candidate to apply to the KPMG case (hereinafter DOJ Transactional Exception). The DOJ Transactional Exception involves disclosure of return information that relates or may relate to a transactional relationship between a person who is or may be a party to the proceeding and the taxpayer which affects, or may affect, the resolution of an issue in such proceeding or investigation.[71] The nature of the transactional relationship between the named taxpayers and KPMG is what was disclosed by the IRS. KPMG is clearly a party to the summons enforcement action. As such, it is possible that the IRS could argue that the release of the taxpayer's name in the context of resolving the summons compliance issue is covered by the DOJ Transactional Exception. However, this is not likely to be a successful argument, as the IRS would have a difficult time proving that the release of the named taxpayer's otherwise confidential information was necessary in any way to resolve whether KPMG was required to comply with the summonses. The IRS did not need to release the names of the named taxpayers in order to enforce the summonses. The IRS could have redacted the names of the individual taxpayers from the petition and made the same

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[68]26 U.S.C. § 6103(h)(2)(C) (emphasis added).

[69]26 U.S.C. § 6103(h)(2)(A).

[70]26 U.S.C. § 6103(h)(2)(B).

[71]26 U.S.C. § 6103(h)(2)(C).

arguments regarding enforcement of the summonses. Had the IRS simply redacted the named taxpayers' confidential information from the petition, the IRS could have still sought compliance from KPMG while protecting the taxpayers' confidential information. As such, it is unlikely that the DOJ Transactional Exception covers the IRS' disclosure.

2. Judicial and Administrative Proceeding Exception

*a. General Rule*

A second of the exceptions which allows disclosure of "return information" involves a necessary disclosure in an administrative or judicial proceeding.[72] Tax Analysts has reported that the IRS is relying on this exception for its disclosure.[73] IRC section 6103(h)(4) provides in pertinent part that:

> A return or return information may be disclosed in a Federal or State judicial or administrative proceeding pertaining to tax administration, but only— if the taxpayer is a party to the proceeding, or the proceeding arose out of, or in connection with, determining the taxpayer's civil or criminal liability, or the collection of such civil liability, in respect of any tax imposed under this title;[74] if the treatment of an item reflected on such return is directly related to the resolution of an issue in the proceeding;[75] if such return or return information directly relates to a transactional relationship between a person who is a party to the proceeding and the taxpayer which directly affects the resolution of an issue in the proceeding;[76] or to the extent required by order of a court pursuant to section 3500 of title 18, United States Code or rule 16 of the Federal Rules of Criminal Procedure, such court being authorized in the issuance of such order to give due consideration to congressional policy favoring the confidentiality of returns and return information as set forth in this title. However, such return or return information shall not be disclosed as provided in the above subparagraphs if the Secretary determines that such disclosure would identify a confidential informant or seriously impair a civil or criminal tax investigation.[77]

[72]26 U.S.C. § 6103(h)(2).

[73]Tax Analysts' reported that:

> According to a source familiar with the case, the government is relying on section 6103(h)(4)(A), which allows for the disclosure of taxpayer information in a judicial tax proceeding if the taxpayer is a party to the proceeding or the proceeding arises out of a determination of the taxpayer's liability.

Amy Hamilton, *Shelter Customer Disclosure Affects California Campaign*, 2002 TAX NOTES TODAY 138-5 (July 17, 2002).

[74]26 U.S.C. § 6103(h)(4)(A).

[75]26 U.S.C. § 6103(h)(4)(B).

[76]26 U.S.C. § 6103(h)(4)(C).

[77]26 U.S.C. § 6103(h)(4)(D).

### b. Application to KPMG Enforcement Action

It has been reported that the IRS believes the first of the four above exception subsections (hereinafter Administrative Collection Exception)[78] applies to the KPMG case.[79] As discussed above, the summons enforcement action was directed at KPMG. The summons enforcement action was not directed at the named taxpayers.[80] The possibility that the named taxpayers could become a party to the proceeding at some future date does not appear strong enough to allow for the IRS to have violated the general rule regarding taxpayer confidentiality. Also, as discussed above, the summons enforcement action did not arise out of, or in connection with, determining the named taxpayer's civil or criminal liability, or the collection of the named taxpayer's civil tax liability. The summons enforcement action did not allege that the named taxpayers owe additional taxes, interest, or penalties. As such, the Administrative Collection Exception does not appear to apply to the IRS' disclosure.

It is also unlikely that the second of the four above exception subsections (hereinafter Administrative Resolution Exception)[81] applies to the KPMG case. As discussed above, the summons enforcement action was not seeking to resolve the treatment on the return of KPMG.[82] KPMG was the "taxpayer" in the summons enforcement action and the summons enforcement action has not called the named

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[78] 26 U.S.C. § 6103(h)(4)(A).

[79] Tax Analysts' reported that:

> In the government's view, attaching KPMG's privilege logs to the petition is permitted under section 6103(h)(4)(A); which allows disclosure which allows disclosure of return information if the taxpayer is a party to a proceeding that arises out of a determination of the taxpayer's liability. The government interprets broadly the definition of return information. KPMG is the taxpayer to the proceeding, and its privilege logs are considered the firm's tax information, according to a source familiar with the case.
>
> As for the argument that the names of KPMG's clients are their own tax information, the government's position is that the privilege logs contain names of recipients of documents. Whether those names are return information depends on whether the names are part of a file or an investigation of those other people, according to the source. The government's analysis for purposes of this enforcement action is that KPMG is the taxpayer under investigation, and that it does not know whether the privilege log descriptions contain anyone else's tax return information.
>
> All the information in the privilege logs are "other data" and are the "return information" of KPMG, the source explained the government's argument. The Justice Department reasons that just because a person's name is mentioned in a document given to the IRS doesn't mean that the document, or that part of the document, is the person's return information. For example, the source explained, information obtained by the IRS in the examination of A becomes the "return information" of A and not B, even if that information also mentions B. In the government's view, the document is the return information of the person whose liability is under examination."

*Taxpayer Confidentiality: Civilian Casualty in War on Shelters?*, 2002 TAX NOTES TODAY 140-1 (July 19, 2002) (hereinafter *Civilian Casualty*).

[80] *Id.*

[81] 26 U.S.C. § 6103(h)(4)(B).

[82] *Id.*

taxpayers' returns into question. As such, the Administrative Resolution Exception does not appear to apply to the IRS' disclosure.

The third of the four above exception subsections (hereinafter Administrative Transactional Exception)[83] provides the IRS' best case for justifying the disclosure of the named taxpayers' information. However, it has been reported that the IRS is not relying on this section.[84] The Administrative Transactional Exception involves disclosure of return information that relates or may relate to a transactional relationship between a person who is or may be a party to the proceeding and the taxpayer which affects, or may affect, the resolution of an issue in such proceeding or investigation.[85] Clearly, there existed a transactional relationship between the named taxpayers and KPMG, and the documents relating to the transactions that linked the named taxpayers and KPMG are what the IRS is seeking to have KPMG disclose. It is clear that KPMG is a party to the summons enforcement action, and thus, the IRS might make the argument that in seeking to enforce compliance with the summonses, the release of the named taxpayer's information is covered by the Administrative Transactional Exception. However, as discussed above, this is not likely to be a successful argument, because the IRS would likely be unable to establish that enforcing compliance with the summonses required the release of the named taxpayer's confidential information. The IRS could have made the same arguments regarding enforcement of the summonses while redacting the names of the involved taxpayers from the petition. As such, it is unlikely that the Administrative Transactional Exception covers the IRS' disclosure.

The last of the four above exception subsections[86] is not likely to apply to the KPMG case because there was no court order issued that required the disclosure.

## IV. SECTION 7431

### *A. General Rule*

An unauthorized disclosure of taxpayer information can lead to a cause of action.[87] The cause of action may arise either where the disclosure is made by an employee of the United States (such as an IRS agent)[88] or by a person not employed by the United States.[89] IRC section 7431(a) provides in pertinent part that:

> If any *officer or employee of the United States* knowingly, or by reason of negligence, inspects or *discloses any return or return information* with respect to a taxpayer *in violation of any provision of Section 6103*, such

[83] 26 U.S.C. § 6103(h)(4)(C).

[84] *See Civilian Casualty*, *supra* note 79, at 140-1.

[85] 26 U.S.C. § 6103(h)(4)(C).

[86] 26 U.S.C. § 6103(h)(4)(D).

[87] I.R.C. § 7431.

[88] I.R.C. § 7431(a)(1).

[89] I.R.C. § 7431(a)(2).

> taxpayer may bring a *civil action for damages* against the United States in a district court of the United States,[90] and
>
> If any person *who is not an officer or employee of the United States* knowingly, or by reason of negligence, inspects or *discloses any return or return information* with respect to a taxpayer *in violation of any provision of Section 6103*, such taxpayer may bring a *civil action for damages* against such person in a district court of the United States.[91]

### *B. Statute of Limitations*

The statute of limitations for bringing the cause of action is two years from the date of discovery by the claimant.[92]

### *C. Good Faith but Erroneous Interpretation Exception*

No cause of action may arise where the disclosing party meets one of the exceptions to Section 7431.[93] One of these exceptions is where the disclosing party has a good faith, but erroneous, interpretation of section 6103.[94]

Section 7431 does not define what constitutes a "good faith" interpretation of Section 6103. Only one District Court has held that the standard is a subjective test,[95] while the Fifth Circuit,[96] Sixth Circuit[97] and Eighth Circuit[98] have all held that the standard is an objective test. For example, in *Diamond v. United States*, the

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[90]I.R.C. § 7431(a)(1) (emphasis added).

[91]I.R.C. § 7431(a)(2) (emphasis added).

[92]I.R.C. § 7431(d) provides in pertinent part: "Notwithstanding any other provision of law, an action to enforce any liability created under this section may be brought, without regard to the amount in controversy, *at any time within 2 years after the date of discovery by the plaintiff* of the unauthorized inspection or disclosure." *Id.* (emphasis added)

[93]I.R.C. § 7431(b) provides in pertinent part: *"No liability shall* arise under this section with respect to any inspection or disclosure- (1) which results from a *good faith, but erroneous, interpretation of section 6103*, or (2) which is *requested by the taxpayer." Id.* (emphasis added.)

[94]I.R.C. § 7431(b)(1).

[95]*See* Taylor v. United States, 186 B.R. 441, 450-51 (N.D. Iowa 1995) (citing to Lebaron v. United States, 794 F. Supp. 947, 954 (C.D. Cal. 1992) (noting that only the district court for the district of Minnesota had interpreted the good faith standard to contain a subjective element).

[96]*See generally* Huckaby v. United States, 794 F.2d 1041, 1048 (5th Cir. 1986); *see also* Gandy v. United States, 234 F. 3d 281 (5th Cir. 2000) (affirming the application of the good faith standard of § 7431 should be determined by an objective standard); Payne v. United States, 289 F.3d 377 (5th Cir. 2002) (noting that the fifth circuit evaluates good faith under an objective standard).

[97]*See Taylor*, 186 B.R. at 450-51.

[98]*See generally Diamond*, 944 F.2d at 431; *see also* Rorex v. Traynor, 771 F. 2d 383, 387 (8th Cir. 1985).

Eighth Circuit held that the "good faith" test is an objective test.[99] The Court's logic was partly based on the fact that the predecessor statute to section 7431 called for an objective standard to apply.[100] In addition, the Court held that the objective test was met by the United States where the United States correctly interpreted section 6103 and the individual agent misinterpreted section 6103.[101] The Court explained that the objective standard is met where a government official is not liable for purposes of the "good faith" test, provided that such official's conduct does not violate statutory or constitutional rights of which a "reasonable person would have known."[102] The Sixth Circuit has held that the objective test is measured by what a "reasonable IRS agent" would have known.[103] As such, the "good faith" test for purposes of section 7431 appears to be a broader test that is more easily met than the test for meeting an exception to Section 6103. Essentially, if an average IRS agent would reasonably believe that the agent was not committing a section 6103 violation, then no Section 7431 cause of action will be permitted, even if an actual violation of Section 6103 has occurred.

### *D. Damages*

A defendant found to have violated this provision[104] could be liable for significant damages.[105] Such damages would be the sum of three amounts.[106] The

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[99] *Diamond*, 944 F.2d at 435-36 (citing to *Rorex,* 771 F.2d at 387).

[100] *Id.*

[101] Husby v. United States, 672 F. Supp. 442, 445 (N.D. Cal. 1987) (holding that the IRS cannot collectively qualify as having met the good faith test); *but see Diamond*, 944 F2d. at 435 n.7 (distinguishing *Husby* by stating that neither legal nor logical support was offered for this holding).

[102] *Diamond*, 944 F.2d at 431 (citing *Rorex*, 771 F.2d at 387) (explaining that government officials are generally shielded from litigation when performing discretionary functions unless such function is a clear violation of statutory rights of a taxpayer) (citing Harlow v. Fitzgerald*,* 457 U.S. 800, 818 (1982).

[103] *See* Gandy v. United States, 234 F.3d 281, 285 (5th Cir. 2000); *see also Payne*, 289 F.3d at 384.

[104] I.R.C. § 7431.

[105] I.R.C. § 7431(c).

[106] I.R.C. § 7431(c) provides in pertinent part:

> In any action brought under section (a), upon a finding of liability on the part of the defendant, the defendant shall be liable to the plaintiff in an amount equal to the sum of-
>
> (1) the greater of –
>
> (A) *$1,000 for each act* of unauthorized inspection or disclosure of a return or return information with respect to which such defendant is found liable, *or*
>
> (B) the *sum of-*
>
> (i) the *actual damages* sustained by the plaintiff as a result of such unauthorized inspection or disclosure, *plus*
>
> (ii) in the case of a *willful* inspection or disclosure or an inspection *or* disclosure which is the result of *gross negligence, punitive damages*, plus
>
> (2) the cost of the action, plus

first of these three is the greater of either (i) $1,000 per disclosure[107] or (ii) actual damages of the taxpayer[108] plus punitive damages where the disclosure was willful or due to gross negligence.[109] The second of these three is the costs of the action.[110]

The final of these is the party's reasonable attorney's fees,[111] where certain conditions are met[112] and these conditions differ depending on whether the United States is the disclosing party[113] or the disclosing party is not the United States.[114]

1. Disclosing Party is Not United States

With respect to where the IRS is not the disclosing party, reasonable attorney's fees may be awarded only where the taxpayer is a "prevailing party" within the meaning provided in 26 U.S.C.S. § 7430(c)(4)(A)(ii).[115] The definition of a "prevailing party" for purposes of I.R.C. § 7430(c)(4)(A)(ii) is a taxpayer who either (1) submits certain filings with the court that justify the taxpayer's procedural requirements for attorney fees or (2) meets certain net worth requirements. These requirements are set forth in 28 U.S.C. § 2412(d)(1)(B) and 28 U.S.C. § 2412(d)(2)(B), both of which are referenced in 26 U.S.C.S. § 7430(c)(4)(A)(ii).

Section 7430(c)(4)(A)(ii) provides that a "prevailing party" is a taxpayer who meets the requirements of the first sentence of section 2412(d)(1)(B) of title 28, United States Code, except to the extent differing procedures are established by rule

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> (3) in the case of a plaintiff which is described in section 7430(c)(4)(A)(ii), *reasonable attorneys fees*, except that if the defendant is the United States, reasonable attorneys fees may be awarded only if the plaintiff is the prevailing party (as determined under section 7430(c)(4)).

*Id.* (emphasis added.)

[107] I.R.C. § 7431(c)(1)(A).

[108] I.R.C. § 7431(c)(1)(B)(i).

[109] I.R.C. § 7431(c)(1)(B)(ii).

[110] I.R.C. § 7431(c)(2).

[111] I.R.C. § 7431(c)(3).

[112] I.R.C. § 7431(c)(3) sets out different conditions depending on whether the United States is the disclosing party. I.R.C. § 7431(c)(3) provides in pertinent part: "In the case of a plaintiff which is described in section 7430(c)(4)(A)(ii), *reasonable attorneys fees*, except that if the defendant is the United States, reasonable attorneys fees may be awarded only if the plaintiff is the prevailing party (as determined under section 7430(c)(4))." *Id.* (emphasis added)

[113] If the United States is the disclosing party, then I.R.C. § 7431(c)(3) provides that reasonable attorneys fees may be awarded for taxpayers described in I.R.C. § 7430(c)(4)(A)(ii) and the taxpayer is the prevailing party as determined in 26 U.S.C. § 7430(c)(4).

[114] If the United States is not the disclosing party, then I.R.C. § 7431(c)(3) provides that reasonable attorneys fees may be awarded for taxpayers described in 26 U.S.C. § 7430(c)(4)(A)(ii).

[115] I.R.C. § 7431(c)(3).

of court and meet the requirements of section 2412(d)(2)(B) of title 28.[116] The first sentence of title 28, section 2412(d)(1)(B) provides:

> A party seeking an award of fees and other expenses shall, *within thirty days of final judgment in the action*, submit to the court an application for fees and other expenses which shows that the party is a prevailing party and is eligible to receive an award under this subsection, and the amount sought, including an itemized statement from any attorney or expert witness representing or appearing in behalf of the party stating the actual time expended and the rate at which fees and other expenses were computed.[117]

In addition, Title 28, section 2412(d)(2)(B) provides in pertinent part:

> "party" means-[118]
>
> an individual whose *net worth did not exceed $2,000,000* at the time the civil action was filed,[119] or
>
> any owner of an unincorporated business, or any partnership, corporation, association, unit of local government, or organization, the *net worth of which did not exceed $7,000,000* at the time the civil action was filed, and which had *not more than 500 employees* at the time the civil action was filed; except that an organization described in section 501(c)(3) of the Internal Revenue Code of 1986 (26 U.S.C. 501(c)(3)) exempt from taxation under section 501(a) of such Code, or a cooperative association as defined in section 15(a) of the Agricultural Marketing Act (12 U.S.C. 1141j(a)), may be a party regardless of the net worth of such organization or cooperative association or for purposes of subsection (d)(1)(D), a small entity as defined in section 601 of title 5.[120]

Lastly, there are special rules set forth for meeting the above net worth requirement where the taxpayer is an estate,[121] a trust,[122] a joint filer,[123] or where the eventual judgment is less than the taxpayer's offer.[124]

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[116] 26 U.S.C.§ 7430(c)(4)(A)(ii).

[117] 28 U.S.C. § 2412(d)(1)(B) (emphasis added).

[118] 28 U.S.C. § 2412(d)(2)(B).

[119] 28 U.S.C. § 2412(d)(2)(B)(i) (emphasis added).

[120] 28 U.S.C. § 2412(d)(2)(B)(ii) (emphasis added).

[121] 26 U.S.C. § 7430(c)(4)(D)(i)(I) provides the following:
Special rules for applying net worth requirement. In applying the requirements of section 2412(d)(2)(B) of title 28, United States Code, for purposes of subparagraph (A)(ii) of this paragraph —
(i) the net worth limitation in clause (i) of such section shall apply to —
(I) an estate but shall be determined as of the date of the decedent's death ….

*Id.*

[122] 26 U.S.C. § 7430(c)(4)(D)(i)(II) provides the following:

### 2. Disclosing Party is United States

Where the disclosing party is the United States, reasonable attorney's fees may be awarded only where the taxpayer both (1) meets the definition of a "prevailing party" for purposes of IRC § 7430(c)(4)(A)(ii), as outlined above, as either a taxpayer who submits certain filings with the court that justify the taxpayer's procedural requirements for attorney fees[125] or meets certain net worth

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Special rules for applying net worth requirement. In applying the requirements of section 2412(d)(2)(B) of title 28, United States Code , for purposes of subparagraph (A)(ii) of this paragraph —

(i) the net worth limitation in clause (i) of such section shall apply to —

(II) a trust but shall be determined as of the last day of the taxable year involved in the proceeding ….

*Id.*

[123]26 U.S.C. § 7430(c)(4)(D)(ii) provides the following:

Special rules for applying net worth requirement. In applying the requirements of section 2412(d)(2)(B) of title 28, United States Code , for purposes of subparagraph (A)(ii) of this paragraph —

(ii) individuals filing a joint return shall be treated as separate individuals for purposes of clause (i) of such section."

*Id.*

[124]26 U.S.C. § 7430(c)(4)(E) provides the following:

Special rules where judgment less than taxpayer's offer.

In general. A party to a court proceeding meeting the requirements of subparagraph (A)(ii) shall be treated as the prevailing party *if the liability of the taxpayer* pursuant to the judgment in the proceeding (determined without regard to interest) *is equal to or less than the liability of the taxpayer* which would have been so determined if the *United States had accepted a qualified offer* of the party under subsection (g) .

(ii) Exceptions. This subparagraph shall not apply to—

(I) any judgment issued pursuant to a settlement; or

(II) any proceeding in which the amount of tax liability is not in issue, including any declaratory judgment proceeding, any proceeding to enforce or quash any summons issued pursuant to this title, and any action to restrain disclosure under section 6110(f) .

(iii) Special rules. If this subparagraph applies to any court proceeding—

(I) the determination under clause (i) shall be made by reference to the last qualified offer made with respect to the tax liability at issue in the proceeding; and

(II) reasonable administrative and litigation costs shall only include costs incurred on and after the date of such offer.

(iv) Coordination. This subparagraph shall not apply to a party which is a prevailing party under any other provision of this paragraph. (emphasis added)

*Id.*

[125]28 U.S.C. § 2412(d)(1)(B).

requirements,[126] and (2) is the "prevailing party"[127] in the lawsuit with the United States as provided in IRC § 7430(c)(4).[128]

IRC § 7430(c)(4) provides in pertinent part:

> *In general*. The term *"prevailing party"* means any party in any proceeding to which subsection (a)[129] applies (other than the United States or any creditor of the taxpayer involved)— [130]
>
> which— [131]
>
> has substantially prevailed with respect to the amount in controversy,[132] or
>
> has substantially prevailed with respect to the most significant issue or set of issues presented,[133] and
>
> which meets the requirements of the 1st sentence of section 2412(d)(1)(B) of title 28, United States Code (as in effect on October 22, 1986) except to the extent differing procedures are established by rule of court and meets the requirements of section 2412(d)(2)(B) of such title 28 (as so in effect).[134]

As such, the general definition of "prevailing party" for purposes of IRC § 7430(c)(4) is a taxpayer who has either prevailed as to the amount in controversy[135] or has prevailed on the issue in the case.[136]

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[126] 28 U.S.C. § 2412(d)(2)(B).

[127] I.R.C. § 7431(c)(3).

[128] I.R.C. § 7431(c)(3).

[129] 26 U.S.C. § 7430(a) provides in pertinent part:
(a) In general.
In any administrative or court proceeding which is brought by or against the United States in connection with the determination, collection, or refund of any tax, interest, or penalty under this title, the prevailing party may be awarded a judgment or a settlement for—
(1) reasonable administrative costs incurred in connection with such administrative proceeding within the Internal Revenue Service, and
(2) reasonable litigation costs incurred in connection with such court proceeding.
*Id.*

[130] 26 U.S.C. § 7430(c)(4)(A).

[131] 26 U.S.C. § 7430(c)(4)(A)(i).

[132] 26 U.S.C. § 7430(c)(4)(A)(i)(I).

[133] 26 U.S.C. § 7430(c)(4)(A)(i)(II).

[134] 26 U.S.C. § 7430(c)(4)(A)(ii).

[135] 26 U.S.C. § 7430(c)(4)(A)(i)(I).

[136] 26 U.S.C. § 7430(c)(4)(A)(i)(II).

However, the United States may not be liable where its position can be substantially justified. With respect to this exception, IRC § 7430(c)(4) provides in pertinent part:

> *Exception if United States establishes that its position was substantially justified*.[137]
>
> *General rule*. A party shall not be treated as the prevailing party in a proceeding to which subsection (a) applies if the United States establishes that the position of the United States in the proceeding was substantially justified.[138]
>
> *Presumption of no justification if Internal Revenue Service did not follow certain published guidance*. For purposes of [the General Rule],[139] the *position of the United States shall be presumed not to be substantially justified if the Internal Revenue Service did not follow its applicable published guidance*[140] in the administrative proceeding. Such presumption may be rebutted.[141]
>
> *Effect of losing on substantially similar issues*. In determining for purposes of [the General Rule][142] whether the position of the United States was substantially justified, the *court shall take into account whether the United States has lost in courts of appeal for other circuits on substantially similar issues.*[143]

Thus, even where the taxpayer has satisfied the general rule, the taxpayer will still not be the "prevailing party" where the United States either: "(1) establishes that its position in the proceeding was substantially justified; [144] or (2) the IRS

[137]26 U.S.C. § 7430(c)(4)(B).

[138]26 U.S.C. § 7430(c)(4)(B)(i).

[139]The bracketed information has replaced the term "clause (i)" to better allow the reader to follow the flow of the statute.

[140]26 U.S.C. § 7430(c)(4)(B)(iv) specifies what constitutes "applicable published guidance." IRC § 7430(c)(4)(B)(iv) provides:

(iv) Applicable published guidance. For purposes of clause (ii), the term "applicable published guidance" means—
- (I) regulations, revenue rulings, revenue procedures, information releases, notices, and announcements, and
- (II) any of the following which are issued to the taxpayer: private letter rulings, technical advice memoranda, and determination letters. (emphasis added)

*Id.*

[141]26 U.S.C. § 7430(c)(4)(B)(ii) (emphasis added).

[142]The bracketed information has replaced the term "clause (i)" to better allow the reader to follow the flow of the statute.

[143]26 U.S.C. § 7430(c)(4)(B)(iii) (emphasis added).

[144]26 U.S.C. § 7430(c)(4)(B).

properly followed its own 'applicable published guidance'[145] in the administrative proceeding,"[146] provided that, the proper authority does not determine that the United States has lost in courts of appeal for other circuits on substantially similar issues[147] and (1) or (2) above is determined by the proper authority.[148]

### *E. Application to KPMG Enforcement Action*

The IRS disclosure of confidential taxpayer names appears to meet the general rule giving rise to a cause of action.[149] As discussed above, the general rule provides, in pertinent part, that a civil cause of action against the United States for damages arises where an employee of the United States knowingly or negligently, discloses any return information with respect to a taxpayer in violation of any provision of section 6103.[150] The petitioning party that disclosed the named taxpayers in the privilege log was the United States. Thus, an employee of the United States must have prepared the petition. It is clear that confidential taxpayer return information was disclosed when the named taxpayers were identified upon the privilege log becoming public information. As such, provided there was a violation of section 6103, the named taxpayers likely meet the general rule for having a cause of action against the United States.

It is unlikely, however, that the named taxpayers would recover damages from a cause of action against the United States for a violation of section 6103. The United States is likely to have a successful defense of any such cause of action by meeting

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[145]26 U.S.C. § 7430(c)(4)(B)(iv) specifies what constitutes "applicable published guidance." IRC § 7430(c)(4)(B)(iv) provides:

> (iv) Applicable published guidance. For purposes of clause (ii), the term "applicable published guidance" means—
>
> (I) regulations, revenue rulings, revenue procedures, information releases, notices, and announcements, and
>
> (II) any of the following which are issued to the taxpayer: private letter rulings, technical advice memoranda, and determination letters. (emphasis added)

*Id.*

[146]26 U.S.C. § 7430(c)(4)(B)(ii).

[147]26 U.S.C. § 7430(c)(4)(B)(iii).

[148]26 U.S.C. § 7430(c)(4)(C) sets forth that if the parties cannot agree as to who the "prevailing party" is for purposes of IRC § 7430(c)(4), then the IRS shall make the determination if the issue is resolved at the administrative level, and the determination shall be made by the court where the issue is resolved in court. IRC § 7430(c)(4)(C) provides in pertinent part:

> *(C) Determination as to prevailing party.* Any determination under this paragraph as to whether a party is a prevailing party *shall be made by agreement of the parties or*—
>
> (i) in the case where the final determination with respect to the tax, interest, or penalty is made at the administrative level, by *the Internal Revenue Service*, or
>
> (ii) in the case where such final determination is made by a court, the *court*. (emphasis added)

*Id.*

[149]I.R.C. § 7431(a)(1).

[150]I.R.C. § 7431(a)(1).

the exception where the disclosing party has a good faith, but erroneous, interpretation of section 6103.[151] In the present case, based on reported IRS commentary, it appears that the IRS had a subjective good faith belief that disclosure of the privilege log did not violate section 6103.[152] However, as discussed above, the objective "good faith" test is met based on what a reasonable IRS agent can be expected to know. As such, it appears that the IRS would have an easier time meeting the section 7431 "good faith" test than the IRS would have meeting an exception to section 6103. Provided that an average IRS agent would believe that there had been no section 6103 violation, then a taxpayer would be unlikely to succeed in bringing a section 7431 cause of action, even if the IRS had committed an actual violation of section 6103.

Here, it also appears that the IRS may satisfy the objective test by arguing that an average IRS agent would believe that the KPMG privilege logs were permitted disclosures under section 6103(h)(4)(A). The IRS would argue that a reasonable IRS agent would believe that disclosure of return information is permitted because KPMG is a party to a proceeding that arises out of a determination of KPMG's liability. The government would argue that KPMG is the taxpayer to the proceeding, and its privilege logs are considered KPMG's tax information. The government would further argue that the privilege logs contain names of recipients of documents and the government would take the position that any disclosure is incidental to KPMG's enforcement action and that as a result, a reasonable IRS agent would not know whether the privilege log descriptions contain anyone else's tax return information. Essentially, the named taxpayers' names became part of KPMG's return information and therefore, since KPMG is the taxpayer under investigation,

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[151]I.R.C. § 7431(b)(1).

[152]Tax Analysts' reported that:

> In the government's view, attaching KPMG's privilege logs to the petition is permitted under section 6103(h)(4)(A); which allows disclosure of return information if the taxpayer is a party to a proceeding that arises out of a determination of the taxpayer's liability. The government interprets broadly the definition of return information. KPMG is the taxpayer to the proceeding, and its privilege logs are considered the firm's tax information, according to a source familiar with the case.
>
> As for the argument that the names of KPMG's clients are their own tax information, the government's position is that the privilege logs contain names of recipients of documents. Whether those names are return information depends on whether the names are part of a file or an investigation of those other people, according to the source. The government's analysis for purposes of this enforcement action is that KPMG is the taxpayer under investigation, and that it does not know whether the privilege log descriptions contain anyone else's tax return information.
>
> All the information in the privilege logs are "other data" and are the "return information" of KPMG, the source explained the government's argument. The Justice Department reasons that just because a person's name is mentioned in a document given to the IRS doesn't mean that the document, or that part of the document, is the person's return information. For example, the source explained, information obtained by the IRS in the examination of A becomes the "return information" of A and not B, even if that information also mentions B. In the government's view, the document is the return information of the person whose liability is under examination."

*See Civilian Casualty*, *supra* note 79, at 140-1.

the IRS may disclose KPMG's return information in the enforcement action under section 6103(h)(4)(A).

Based on the lower threshold, it is likely that the IRS would succeed on the "good faith" defense of any section 7431 cause of action. For purposes of this Article, it is assumed that the IRS could meet this standard by evidencing that KPMG was the taxpayer in the summons enforcement action and that the IRS' internal policies allowed disclosure of third party names when filing a petition to enforce KPMG's summonses. If Tax Analysts succeeds in its FOIA requests of the government, the decision making process of the government on this matter will be revealed and we will be able to determine whether this assumption is correct.

## V. CONCLUSION

The IRS has been battling the former "Big Five" (now "Big Four") accounting firms and certain other promoters for years over their alleged marketing of tax shelters.[153] On January 28, 2002, the IRS issued its first summons to one of the Big Four accounting firms, KPMG, requesting that KPMG provide documents relating to two alleged tax shelters[154] allegedly promoted by KPMG.[155] The IRS subsequently issued several other summonses to KPMG relating to additional alleged tax shelters purportedly promoted by KPMG.[156] While providing the IRS with several boxes of documents and sworn testimony, KPMG also created a privilege log containing a list of documents relating to participants in the alleged tax shelters.[157] The IRS responded to KPMG's document production and privilege log by refuting KPMG's privilege claim and requesting additional documents not previously requested.[158] On July 9, 2002, the IRS filed a summons enforcement action lawsuit against KPMG.[159] The IRS included the privilege log as part of its petition in the summons enforcement action.[160] The IRS did not redact the names of the taxpayers who whose documents were contained in the privilege log, regardless of the fact that the taxpayers were not parties to the IRS lawsuit.[161] The public disclosure of these taxpayers' relationship with KPMG in the context of alleged tax shelter activity became public knowledge. The WSJ disclosed many of the taxpayer names in a front page article.[162] The

[153]Tax Notes Today has reported that all the former Big Five accounting firms have been served with summonses relating to the alleged promotion of tax shelters. *See PWC Deal Heads Off Shelter Summons Enforcement*, 2002 TAX NOTES TODAY 125-1 (June 27, 2002).

[154]The two alleged tax shelters were the FLIP and the OPIS strategies. *See* Petition, *supra* note 8.

[155]*See* Lupi-Sher, *supra* note 22, at 133-34.

[156]*See* Petition, *supra* note 8.

[157]*See* Lupi-Sher, *supra* note 22, at 133-34.

[158]The IRS claimed that KPMG had failed to produce 1,129 of the 1,162 documents listed in the privilege log. *See* Petition, *supra* note 8.

[159]*Id.*

[160]*Id.*

[161]*Id.*

[162]*Id.*

disclosure of the taxpayer names caused a strong public reaction and subsequently, the IRS Office of Chief Counsel issued new guidelines that likely would have foreclosed the disclosures had the guidelines been in existence prior to the public disclosure.[163] Freedom of Information Act requests have been made by Tax Analysts to the U.S. Treasury Department,[164] the IRS[165] and DOJ[166] seeking to discover internal government documents relating to who made this decision and how it was made. Section 6103 provides that the IRS must maintain the confidentiality of certain taxpayer information, subject to certain exceptions.[167] Section 6103(a) sets forth the general rule that taxpayer "return information" is generally confidential, subject to certain exceptions.[168] Section 6103(b)(2) provides that "return

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[163] *IRS Release*, *supra* note 34.

[164] Tax Analysts sent a Freedom of Information Act ("FOIA") request to the U.S Treasury Department seeking several documents, as described below:

> In particular, the FOIA request seeks any materials discussing the decision to attach privilege logs containing KPMG client names. … Tax Analysts has asked for copies of any documentation discussing the decision to release to the press the petitions and some attachments on the day filed, and the court filings in electronic form soon afterward. The FOIA requests also seek memos or documents relating to the letters to the editor of the Wall Street Journal that were written by officials in the Treasury, IRS, and Justice Department, including draft versions of the letters.

Dobrovir, *supra* note 15, at 153-28.

[165] Tax Analysts sent a Freedom of Information Act or FOIA request to the IRS seeking several documents, as described below:

> In particular, the FOIA request seeks any materials discussing the decision to attach privilege logs containing KPMG client names. … Tax Analysts has asked for copies of any documentation discussing the decision to release to the press the petitions and some attachments on the day filed, and the court filings in electronic form soon afterward. The FOIA requests also seek memos or documents relating to the letters to the editor of the Wall Street Journal that were written by officials in the Treasury, IRS, and Justice Department, including draft versions of the letters.

Dobrovir, *supra* note 15, at 153-39.

[166] Tax Analysts sent a Freedom of Information Act ("FOIA") request to the U.S Justice Department seeking several documents, as described below:

> In particular, the FOIA request seeks any materials discussing the decision to attach privilege logs containing KPMG client names. … Tax Analysts has asked for copies of any documentation discussing the decision to release to the press the petitions and some attachments on the day filed, and the court filings in electronic form soon afterward. The FOIA requests also seek memos or documents relating to the letters to the editor of the Wall Street Journal that were written by officials in the Treasury, IRS, and Justice Department, including draft versions of the letters.

Dobrovir, *supra* note 15, at 153-41.

[167] 26 U.S.C. § 6103.

[168] 26 U.S.C. § 6103(a) provides in pertinent part:

> (a) General Rule.
>
> Returns and return information shall be confidential, and except as authorized by this title-
>
> (1) No officer or employee of the United States,
>
> (2) No officer or employee of any State, any local law enforcement agency receiving information under subsection (i)(7)(A), any local child support

information" includes taxpayer names as well as other information.[169] It is likely that the United States violated the general rule of section 6103 because the United States improperly disclosed taxpayer names in the KPMG case. In addition, it is not likely that the United States can rely on any of the exceptions to section 6103, as neither DOJ nor the IRS:

> (1) alleged in the summons enforcement action that the named taxpayers owe additional taxes, interest or penalties, nor did the summons enforcement action arise out of, or in connection with, determining the named taxpayer's civil or criminal liability, or the collection of the named taxpayer's civil tax liability;[170]
>
> (2) were seeking via the summons enforcement action to resolve the treatment on the return of KPMG;[171] or
>
> (3) disclosed the return information pursuant to a transactional relationship between the named taxpayer and KPMG which affects, or may affect, the resolution of an issue in the summons enforcement action.[172]

Section 7431 provides redress for taxpayers in which such confidential taxpayer information is improperly disclosed.[173] Although the IRS disclosure of confidential taxpayer names appears to meet the general rule giving rise to a cause of action,[174] it is unlikely that the named taxpayers would recover damages because the United States is likely to meet the exception where the disclosing party has a good faith, but erroneous, interpretation of section 6103.[175] The United States would meet this

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> enforcement agency, or any local agency administering a program listed in subsection (l)(7)(D) who has or had access to returns or return information under this section , and
>
> (3) No other person (or officer or employee thereof) who has or had access to returns or return information under subsection (e)(1)(D)(iii), paragraph (6), (12), or (16) of subjection (l), paragraph (2) or (4)(B) of subsection (m), or subsection (n), shall disclose any return or return information obtained by him in any manner in connection with his services as such an officer or an employee or otherwise or under the provisions of this section. For purposes of this subsection, the term "officer or employee" includes a former officer or employee.

*Id.*

[169]26 U.S.C. § 6103(b)(2)(A) provides in pertinent part that "return information" means "a *taxpayer's identity,* the nature, source, or amount of his income, payments, receipts, deductions, exemptions, credits, assets, liabilities, net worth, tax liability, tax withheld, deficiencies, over assessments, or tax payments. …" *Id.* (emphasis added.)

[170]26 U.S.C. § 6103(h)(2)(A)-(h)(4)(A).

[171]26 U.S.C. § 6103(h)(2)(B)-(h)(4)(B).

[172]26 U.S.C. § 6103(h)(2)(C)-(h)(4)(C).

[173]I.R.C. § 7431.

[174]I.R.C. § 7431(a)(1).

[175]I.R.C. § 7431(b)(1).

exception by showing that a reasonable IRS agent would have believed that the agent could disclose the information. For purposes of this Article, it is assumed that the IRS would be able to meet this threshold by showing that KPMG was the taxpayer in the summons enforcement action and that its internal policies dictated that it may disclose third party names when filing a petition to enforce KPMG's summonses. Assuming Tax Analysts is successful in its FOIA requests of the government, the decision making process of the government on this matter will illuminate whether this assumption is borne out by the facts.